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DIRECTORATE OF
INTELLIGENCE

# Intelligence Memorandum

## *Japan: Increasing Pressure On The Yen*

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
June 1971

INTELLIGENCE MEMORANDUM

# JAPAN: INCREASING PRESSURE ON THE YEN

## Introduction

The international monetary turmoil last month has focused increasing attention on the Japanese yen as a candidate for revaluation. Several European countries with strong payments positions have already revalued or allowed their currencies to float upward. The Japanese, however, have so far put off revaluation, despite large surpluses since mid-1968 and rapidly growing foreign exchange reserves, which rose over $1 billion in May. Moreover, many foreign governments and business leaders have felt for some time that Japan's soaring exports partly reflect undervaluation of the yen. This memorandum analyzes the recent buildup in Japanese foreign exchange reserves and evaluates Tokyo's likely attitude toward yen revaluation in the next few months.

## Discussion

### Background

1. The need for yen revaluation has been actively discussed both inside and outside of Japan since mid-1968 because of persistent balance-of-payments surpluses. Japan's foreign exchange reserves rose from $2 billion on 30 June 1968 to $4.8 billion at the end of 1970, largely as a result of current account surpluses, which have been running about $2 billion annually. These surpluses were recorded concurrently with an annual gross national product (GNP) expansion of 18% in nominal terms and 12.5% in real terms.

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*Note: This memorandum was prepared by the Office of Economic Research and coordinated within the Directorate of Intelligence.*

2. [redacted] 25X6 Tokyo has attempted to hold down the growth of its reserves in an effort to dampen international criticism. Restrictions on outward capital movements have been liberalized [redacted] 25X6 For example, World Bank loans have been paid off ahead of schedule and dollar loans have been made to international financial organizations which are repayable at Tokyo's request. 1/ At the same time, the Japanese government has insisted that consideration of yen revaluation is premature because it is much too early to assess the impact of the ongoing program of liberalization of trade and capital restrictions. In essence, the Japanese position has been that determination of whether the yen is really overvalued must wait until the effects of their supposed liberalization measures are visible.

3. Tokyo's efforts to delay yen revaluation are prompted in part by the belief that it would have adverse political repercussions. Many Japanese exporters, especially those facing increasing competition from less developed countries – such as the politically important textile producers -- have argued that their profit margins are so slim that revaluation would drive them out of business. In addition, businessmen whose firms have large amounts of dollar assets – for example, those with long-term loans repayable in dollars and contracts to build ships stipulated in dollars -- mention the large losses they would incur.

4. While government officials have repeatedly stated that yen revaluation is out of the question in the near term, the subject has increasingly become a topic of conversation among important segments of the business community. That the possibility of revaluation is taken seriously in Japanese business circles is perhaps best illustrated by the yen payments clauses the Japanese shipbuilding industry began inserting into contracts with foreign customers last year and a study published last June by Mitsui Bank assessing the probable effect of revaluation on major Japanese industries.

## Current Problems

5. Foreign exchange reserves have grown rapidly since September 1970 despite Tokyo's efforts to hold them down. A slowdown in real

*1. Since July 1970, Japanese foreign exchange reserves as reported by Tokyo are $440 million lower than the IMF figures appearing in* International Financial Statistics. *This discrepancy is due to Japanese loans to international financial organizations which the Japanese do not count as reserves. The IMF reserve figures are used in this memorandum.*

economic growth to an annual rate of less than 10% has cut into the import growth, but exports continued to climb. Lower interest rates in the United States than in Japan caused Japanese borrowers to shift to the United States for financing, and foreigners especially since February 1971 bought relatively large quantities of Japanese securities. Consequently, reserves reached $6.1 billion at the end of April 1971 which was $2.1 billion higher than the end of September 1970. 2/

6. The recent monetary disturbances in Europe and Bonn's 5 May decision to float the mark focused even more attention on the yen as a candidate for revaluation. Many Japanese businessmen, believing revaluation imminent, began hedging by converting their current dollar holdings into yen and contracting for dollar liabilities to offset losses they would incur on their dollar assets after revaluation. These efforts were mainly responsible for some $600 million in net short-term inflows during May. In addition, the highly favorable current account surplus during last month (about $250 million) and large net purchases of Japanese securities ($200 million) continued (see the table). As a result, total Japanese foreign exchange reserves increased a record $1.1 billion in May or to a striking $7.2 billion.

Japanese Balance of Payments
1971

Million US $

| | Jan | Feb | Mar | Apr | May a/ |
|---|---|---|---|---|---|
| Current account balance | -186 | 212 | 462 | 380 | 250 |
| Capital movements | 190 | 123 | 128 | -186 | 850 |
| Purchases of Japanese securities | 30 | 132 | 237 | 200 | 200 |
| Other capital movements | 160 | -9 | -109 | -386 | 650 |
| Change in reserves | 133 | 336 | 590 | 194 | 1,100 |
| Special Drawing Rights (SDRs) | 129 | 1 | -- | -- | -- |
| Other | 4 | 335 | 590 | 194 | 1,100 |

a. *Preliminary.*

2. *The increase included $130 million in new Special Drawing Rights (SDRs).*

7. The May dollar inflow occurred because there are some loopholes to Tokyo's tight foreign exchange controls. In an effort to close them, the Japanese Finance Ministry announced on 17 May that foreign buying of unlisted Japanese bonds would be prohibited for an indefinite period. According to press reports, recent purchases of unlisted bonds and debentures have accounted for more than 80% of total bond purchases. Unlisted bonds and debentures have definite disadvantages for the purchaser, including the lack of liquidity, because such instruments are not eligible for discount by commercial banks with the Bank of Japan and lack a market-determined price. Movement into such instruments probably reflected a significant widening of yen speculation as foreign purchasers were willing to accept a more risky and relatively illiquid asset to get into yen.

8. More important, Tokyo's 17 May restrictions attempted to halt those hedging operations by Japanese businessmen which resulted in a dollar inflow. Japanese exporters have been anxious to sell dollars forward to insure against loss from revaluation on their dollar-denominated export contracts, but there have been few buyers. Importers and others with dollar-denominated liabilities were naturally less willing to purchase dollars forward because revaluation would result in a reduction in their debt. The resulting imbalance between supply and demand in the forward dollar market pushed up the discount rate on three-month forward dollars from about 1.5% prior to 5 May to about 6% subsequent to that time. Unwilling to take such a loss, many potential dollar sellers borrowed dollars from Japanese foreign exchange banks and foreign banks and converted these dollars into yen in the government-supported spot market. Such borrowing further increased Japanese foreign exchange reserves, which in turn added to the revaluation psychology. On 17 May, controls were placed on dollar lending by Japanese banks to Japanese firms, and banks were restricted from guaranteeing the foreign borrowing of Japanese firms. Some loopholes remain, however. Many Japanese firms, for example, have a sufficient credit standing so they can still borrow in the United States. Preliminary data on the Bank of Japan's purchases of dollars in the spot market since 17 May indicate that these actions have not yet succeeded in substantially reducing the dollar inflow.

## Outlook

9. Obviously Japan cannot continue to accumulate reserves at the current record rate without incurring sharp criticism from the United States and other major developed countries. The growth of reserves is unlikely to continue at this rate much longer. Tokyo's expanding capital controls and determination to slow the reserve buildup will probably soon cut the inflow substantially. [redacted] 25X1

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10. Moreover, an acceleration of Japanese economic activity expected by most Japanese economists by this fall will spur imports and reduce the present exceptionally high trade surplus. On a seasonally adjusted annual basis the trade surplus ran $6.6 billion (imports c.i.f.) during the January-April period compared with $0.5 billion for the whole of 1970. When imports do increase to a more normal expansion rate, the current account surplus will likely decrease to between $2.0 billion and $2.5 billion annually from well above the annual rate of $3 billion reached during the past eight months.

11. Even if Tokyo can block capital inflows and a higher import expansion rate is reached, Japan is still likely to accumulate reserves at the rate of $1 billion or more a year in the near future. 3/ Continued rapid export growth is expected, barring a prolonged worldwide depression or a major global trade war. Real reduction of Japan's import barriers is likely to continue to be slow because such moves have an adverse impact on industries and workers with political muscle. The already rapid expansion rate of Japanese long-term capital expenditures abroad can hardly be expected to increase significantly. With continuing surpluses of $1 billion or more each year and only minimally effective import liberalization moves, Japan undoubtedly will be continuously taken to task by the United States, its major trading partner, and by Western Europe, which is just now beginning to feel the impact of larger quantities of Japanese goods.

12. Tokyo's present public position is that revaluation is not warranted until the effects of import liberalization are apparent and certainly not until after the reversion of Okinawa, which will probably not take place before the Spring of 1972. The Okinawan case is essentially a political issue because Prime Minister Sato and his Liberal Democratic Party would definitely not endear themselves to the Okinawans by revaluing

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the yen while Okinawa remained a dollar area. Undoubtedly, however, Tokyo could devise a system to offset Okinawan losses.

13. [redacted] There is also a growing feeling in Japan that revaluation is preferable to real import liberalization as a means of reducing the surpluses. 25X6

14. Under these circumstances, a yen revaluation will likely take place within the next year or so. The timing will be largely determined by the pressures applied by foreign governments. In addition, relatively volatile international monetary movements would tend to advance the revaluation date. But in any case, revaluation is likely to be too small -- less than 10% -- to have a major corrective effect on Japan's balance-of-payments surplus. Lower yen profits on exports would tend to be offset by lower import costs. Because Japan must import a much higher portion of its raw material needs than other developed countries, this balancing effect would be relatively greater than elsewhere. Tokyo would probably continue its current practice of assisting Japanese firms adversely affected by changes in international trade and monetary patterns.



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